ESG investing: a hard look at impact

The NYU Stern Center for Sustainable Business published a study looking at the relationship between ESG and financial performance in more than 1,000 research papers from 2015 – 2020

Better financial performance due to ESG is more noticeable over longer time horizons

The model suggests that, everything else being constant, a study with an implied long-term focus is 76 per cent more likely to find a positive or neutral result. Some recent papers were optimistic about how markets value long-term commitments; one found that CEOs' communication of "long-term plans" resulted in an abnormal positive reaction by the stock market.

An ESG integration strategy outshines negative screening approach

ESG integration seemed to perform better than negative screening and divesting, with 33 per cent of the studies finding alpha and 53 per cent finding neutral or mixed results. The subgroup of papers analysing pooled investment strategies (combining everything with some type of ESG label) was least convincing in terms of showing a positive association. It might be because too many different strategies were combined together.

ESG investing provides downside protection in a crisis

ESG investing appears to provide asymmetric benefits. Investor studies, in particular, seem to demonstrate a strong correlation between lower risk related to sustainability and better financial performance. During the financial crisis, it was found that German green mutual funds delivered risk-adjusted returns slightly better than their peers; during non-crisis they were equal to conventional funds, but better than socially responsible investing funds. FTSE4Good, a set of ESG stock market indices, also recovered its value quicker after the 2008 financial crash.

Corporate sustainability moves may drive better financial performance

Sustainability strategies implemented at the corporate level can drive better financial performance through mediating factors – i.e. the sustainability drivers of better financial performance such as more innovation, higher operational efficiency, and better risk management.

Managing for a low carbon future improves financial performance

Research on mitigating climate change through decarbonisation strategies is fairly recent, but finds strong evidence for better financial performance for both corporates and investors. This comes as 59 studies on the relationship between low carbon strategies and financial performance have been published in the last five years – though to be clear, not in the three elite finance journals (Journal of Finance, Journal of Financial Economics, and Review of Financial Studies). Still, most uncovered a positive result.

ESG disclosure on its own does not drive financial performance

Just 26 per cent of studies that focused on disclosure alone found a positive correlation with financial performance compared to 53 per cent for performance-based ESG measures (e.g. assessing a firm's performance on issues such as greenhouse gas emission reductions). While what gets measured does matter, measuring ESG metrics without an accompanying strategy seems ineffective.

Source: NYU